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Vice Chairman Roger W. Ferguson, Jr.
Governor Susan Schmidt Bies
Governor Donald L. Kohn
Governor Mark W. Olson
Board of Governors of the Federal Reserve System
Washington, DC 20551

Dear Vice Chairman Ferguson and Governors Bies, Kohn, and Olson:

Thank you for allowing us to present our concerns about adjustable rate mortgages at the October Consumer Advisory Council meeting. We appreciate the Board's focus on the important economic and consumer protection issues surrounding these loan products. We would like to follow up on the specific questions raised by Governor Bies and Sandra Braunstein as to the efficacy of current disclosures and methods for improving the disclosures. We are sending this letter in our capacities as Consumer Advisory Council members, current and past.

<u>Current ARM Disclosures</u>

The current disclosure requirements for adjustable rate mortgages are inadequate. They are not required to be loan specific, there are few penalties for failing to provide them, and what detailed information is given is not given at closing. Fundamentally, the existing disclosures do not provide consumers with basic information that allows consumers to assess the interest rate risk in a meaningful way.

The existing disclosure regime for closed-end ARMs under Section 128(a)(14) of the Truth in Lending Act, as implemented by the Board in Regulation Z §226.19, requires consumers to be given information about adjustable rate mortgages when they first apply for the credit. These are generic disclosures. They disclose that the consumer is applying for an adjustable rate loan, provide some basic information about how ARMs work, and typically provide an example of how payments on a $10,000 loan might have changed, using a historical index and margin. The Board permits creditors to disclose the actual program maximum increases, but in our experience few creditors choose that option. Creditors are also required to provide the Board's handbook on ARMs, which provides a basic overview of how ARMs work. For closed end credit, there may be no statutory damage liability for failing to give these disclosures.[1] Few of our clients ever get these initial disclosures.

These existing disclosures, even if given, are of little use to consumers. The creditor does not tell the consumer the critical practical effect of the variable rate feature: what the payment amount will reach if the interest rate adjusts to the maximum. The creditor is required only to disclose the payment that would be required on a hypothetical $10,000 loan if the interest rate rises to the maximum or to the 15-year historical high. As is clear from the Consumer Federation of America July 2004 survey, most consumers cannot calculate the payment change for an adjustable rate mortgage. According to the survey, all respondents underestimated the annual increase in the cost of monthly mortgage payments if the interest rate went from 6% to 8% by approximately 30%. Younger, poorer, and less-educated respondents underestimated by as much as 50%.[2] Most consumers minimize the interest rate risk by underestimating the amount by which payments are likely to increase.

TILA also requires a consumer who is entering into a closed-end home-secured loan to be given a second set of disclosures at closing. These disclosures give almost no information about the adjustable rate feature of the mortgage. They do not disclose the maximum payment, the maximum interest rate, or the index used. The creditor only discloses the existence of a variable rate feature: "Your loan contains a variable-rate feature. Disclosures about the variable-rate feature have been provided to you earlier."[3] This uninformative disclosure is placed in a non-prominent spot on the disclosure statement. It refers to disclosures that the consumer may (or may not) have received months earlier, that were not loan specific, and that the consumer is unlikely to have at closing. Even though the actual terms of the consumer's loan are known at closing, the disclosure does not state the maximum interest rate, apply the potential interest rate increase to the consumer's actual principal, or state what the consumer's payment could reach.[4] Although the creditor knows what the maximum payment will be, the creditor does not tell the consumer.

These weak disclosures provided at closing virtually ensure that consumers will not understand the risks they are facing when they enter into ARMs. They are not even sufficient to alert consumers that the interest rate is adjustable. Consumers often apply for fixed rate loans and believe they have a fixed rate loan, only to discover upon the first payment adjustment that the loan was an ARM. Even consumers who knowingly obtain variable rate loans are not told the single most important piece of information that they need in order to evaluate the riskiness of the loan - the maximum potential payment. Since consumers are likely to lose their homes if the

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[1] A few courts have ignored the broad applicability of § 130(a)("any creditor who fails to comply with any requirement of this part") in favor of reading the final paragraph of § 130(a) as granting statutory damages only for violations of specific subsections of §§ 127 and 128. *See* Brown v. Payday Check Advance, 202 F.3d 987 (7th Cir. 2000); Baker v. Sunny Chevrolet, 349 F.3d 862 (6th Cir. 2003). Concerns about these cases and their interpretation of § 130 are discussed in National Consumer Law Center, Truth In Lending § 8.6.5.3 (5th ed. 2003 & Supp.).
[2] "Lower-Income and Minority Consumers Most Likely to Prefer and Underestimate Risks of Adjustable Mortgages," p. 3, Consumer Federation of America press release, July 26, 2004, *available at* http://www.consumerfederation.org/releases.cfm#Consumer%20Literacy
[3] Reg. Z § 226.18(f)(2); Appx. H-4(B).
[4] The final disclosures do disclose the payment schedule. However, the disclosed payment schedule is calculated based solely on the index rate then in effect. Only in the case of a teaser rate, that is an initial rate lower than the fully-indexed rate, is there any adjustment in the payment schedule to reflect the adjustable nature of the mortgage.

payment increases to an amount they cannot afford, they should be given this information. The failure to give this information may account, in part, for the high rates of default among subprime ARMs relative to fixed rate subprime mortgages.[5]

Some subprime lenders underwrite loans only for the teaser rate, making default highly likely.[6] Even prime lenders do not underwrite the loan for the maximum possible payment, but only for the fully indexed payment. The result is that neither consumers nor the market is taking the risk of interest rate increases into account, creating a danger of economic instability. The Interagency Guidance on Nontraditional Mortgage Products issued by the Board and other federal banking agencies on December 20, 2005, recognizes this risk and the importance of informing consumers of its existence and scope.

<u>Our Suggested Amendments to Regulation Z for Closed-End ARMs</u>

To address these problems, we urge the Board to require the TIL disclosures given at closing to state clearly and conspicuously the maximum interest rate that could be imposed, the maximum payment amount that could be required, and information about where to find the index used. To be effective, this critical information should be placed in the federal box. Requiring this disclosure in addition to the current ARM disclosures at application would be a minimal additional burden on creditors, since they are already required to make disclosures at closing.

We believe that in order to be effective, disclosures must be loan specific, contain the information that the consumer is most focused on, and be given at consummation or close enough to closing so that the consumer understands their importance. There must also be meaningful consequences attached to the creditor's failure to comply, including the possibility of statutory damages.

Our proposal is that the Board make the following changes in Regulation Z for closed-end home-secured loans:

1. *Amend § 226.18(g) by adding subsection (3)*:

> (3) In a transaction secured by the consumer's principal dwelling in which the annual percentage rate may increase after consummation, the creditor must disclose the following in addition to the initial payment schedule:
>
> > (i) The fact that the credit involves a variable rate and that the consumer's interest rate and monthly payment can change substantially over time;
> > (ii) The number of months to which the initial interest rate applies;

[5] Statistical evidence suggests that subprime ARMs are significantly more likely to result in foreclosure than subprime fixed rate mortgages. Roberto Quercia, Michael A. Stegman, Walter R. Davis, The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments, January 2005, p. 28-29, *available at* www.kenan-flagler.unc.edu/ assets/documents/foreclosurepaper.pdf; Lynne Dearborn, Mortgage Foreclosures and Predatory Practices in St. Clair County, Illinois, 1996-2000, July 2003, p. 23.

[6] *See, e.g.*, Aames Mortgage Trust 2001-1 Mortgage Pass-Through Certificates, Series 2001-1, Aames Capital Corporation as Sponsor, Countrywide Home Loans, Inc. as Servicer, Prospectus Supplement to Prospectus dated March 13, 2001, S-10.

(iii) The maximum interest rate and monthly payment that could result from variable rate increases, based on the initial principal;
(iv) A reference to an Internet site or a widely-circulated newspaper feature where the consumer can find the index.

2. *Delete § 226.18(f)(2).*

In addition, we ask the Board to revise the model form for ARMs in accord with the suggested form attached as Appendix A.

Timing of Disclosures

At the Consumer Advisory Council meeting there were questions about whether disclosing the worst case scenario only at closing would be soon enough to enable consumers to make informed choices. For non-purchase money mortgages, the consumer has three days after closing to review the documents and decide whether to cancel. Giving this disclosure at closing would be effective because it would mean that consumers would have this information during that critical window, when they are focused on the loan.

Disclosure at closing is certainly less than ideal for purchase money mortgages, where there is no three day right of rescission. However, there is currently no other time at which the creditor is required to provide binding information about the loan. (Indeed, early disclosures for open-end credit need not even be given in a form the consumer can keep before consummation.) We believe that disclosing this information in the TIL disclosures given at closing is the best option, under the current disclosure regime.

Changing the final TILA disclosure form would also change the form used by creditors when they provide estimated disclosures that Section 128(b)(20) requires at the loan application stage for both purchase and non-purchase residential mortgage transactions. This would mean that borrowers would receive some loan specific information with the estimated disclosures, and would be able to compare, to the extent they are able to now, the estimates with the final loan offered. If both the estimated disclosures and the final disclosures included the worst case scenario, the consumer would have some advance notice of this important information.

There are significant problems with relying on the early, estimated disclosures to convey important information, however. While these early disclosures are important to facilitate comparison shopping, they may be given so long before closing that their accuracy is questionable and their effectiveness is minimized. The early disclosures are required to be given three days from the creditor's receipt of the completed loan application, a date that is subject to wide variation.[7] Creditors may give these notices months before the actual closing, or may give them only a few days beforehand. The estimated disclosures need not and often do not bear any close relationship to the actual loan terms. For closed-end mortgage loans, if the estimated disclosures turn out to be inaccurate, the creditor need only provide the accurate disclosures at closing. Reg. Z § 226.19(a)(2). In addition, failure to provide the early disclosures or to provide

[7] For example, if a broker takes the consumer's application, the three days begin to run only when the actual lender receives it. OSC § 226.19(a)(1)-3.

them accurately may not give rise to statutory damages, so there may be no self-enforcement mechanism.[8]

The Board could address part of the problem posed by the estimated disclosures by altering its regulation for the timing of the early, estimated disclosures. Under Section 128(b)(2), these disclosures are to be:

> made in accordance with regulations of the Board under section 1631(c) of this title before the credit is extended, or shall be delivered or placed in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

We recommend that the Board revise Reg. Z § 226.19(a)(1), which implements this timing requirement, to read as follows:

> In a residential mortgage transaction subject to the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) the creditor shall make good faith estimates of the disclosures required by section 226.18 *seven days* before consummation, or shall deliver or place them in the mail not later than three business days after the creditor receives the consumer's written application, whichever is earlier.

This amendment would mean that the consumer would get the estimated disclosures at least seven days before closing, regardless of when the creditor received the consumer's written application. The Board should also delete footnote 43 to Reg. Z § 226.18(f)(1).

In addition, we recommend that the Board add a requirement that, when the estimated disclosures become inaccurate in closed-end home-secured transactions, corrected disclosures be given before closing as well as at closing. Getting the corrected estimated disclosures only at closing makes them of far less use to the consumer, and invites the bait and switch tactics that we see so often in transactions involving low-income consumers. We recommend that a new § 226.19(a)(3) be added to Regulation Z as follows:

> *If the annual percentage rate at the time of consummation varies from the annual percentage rate disclosed earlier by more than 1/8 of 1 percentage point in a regular transaction or more than ¼ of 1 percentage point in an irregular transaction, or is changed from a fixed rate to a variable rate or from a variable rate to a fixed rate, the creditor shall disclose all the changed terms no later than seven days before consummation or settlement.*[9]

This addition to Regulation Z is within the Board's authority under Section 105(a) of the Act, which allows the Board to promulgate regulations that implement Congressional mandates or fill in gaps where Congress was silent. In § 128(b)(2), Congress requires early disclosures for

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[8] *See, e.g.,* Baker v. Sunny Chevrolet, 349 F.3d 862 (6th Cir. 2003). We believe this is an incorrect interpretation of § 130, however.

[9] A corresponding revision would need to be made to Reg. Z § 226.17)(f) and footnote 39.

certain transactions within three days of application and at consummation if the early disclosures are not accurate. This provision does not prohibit additional disclosures at other times.

Making these additions to Regulation Z would strengthen the potential use of the estimated disclosures for shopping, and would ensure that the consumer had the opportunity to examine the terms of the loan before becoming bound. These additions would not be a substitute for requiring the disclosures at closing, primarily because the disclosures at closing are the ones that matter, both to an individual consumer who must now accept or reject this loan, and to the lender, since only the final disclosures are clearly tied to statutory damages.

<u>Industry Concerns</u>

In the Consumer Credit Committee's discussion the day before the full Council meeting in October 2005, the creditor representatives stated that they currently do not disclose the worst case scenario to consumers. They stated, however, that if all lenders had to disclose the worst case scenario, they were confident that they could compete successfully. They stressed that a best practices approach would not work. Such an approach would serve only to give a competitive advantage to lenders who chose not to follow those practices, because they would be able to soft-pedal the potential effects of rate increases. These are the same lenders who are most likely to be engaging in dishonesty and overreaching, to whom it is most important to apply these requirements.

<u>Home Equity Lines of Credit</u>

Home equity lines of credit (HELOCs) present somewhat different problems. Slightly more information is given, both at application and at the account opening, the HELOC equivalent of a loan closing. However, this information is typically given in a narrative framework and is not strictly segregated, often making it difficult for consumers to focus on the critical information. The lack of uniform format of the current HELOC disclosures makes it very difficult for consumers to absorb the information or compare different offers.

The actual amount of credit extended may not be known at consummation, since HELOCs are an open-end credit product. We therefore propose that the worst case scenario be based on the maximum amount of credit that may be extended under the plan. Such a requirement is particularly appropriate because, in the typical subprime HELOC that we see, the total line of credit (or just slightly under the total line of credit, or, occasionally, slightly *over* the total line of credit) is extended to the borrower at closing. Even in prime HELOCs, a significant portion of the line of credit may be extended to the borrower at closing. Using the maximum amount of the credit limit to make this calculation should exert pressure on creditors to be more conservative when deciding the credit limit for any particular consumer. This downward pressure should help to stem the tide of unnecessarily large lines of credit.

Worst case scenario disclosures based on the maximum amount of credit extended should be given at closing to these borrowers. Borrowers should also be clearly told how much credit has been extended and how much remains. The Board should mandate a uniform, tabular disclosure format for HELOC disclosures, that segregates the HELOC disclosures and other important information from the lengthy contract terms. We would ask the Board to provide a model form for the HELOC disclosures. A sample disclosure form is attached as Appendix B.

We urge the Board to take action now to require that the actual worst case scenario be disclosed for closed-end home-secured loans. This change could be accomplished quite simply, with only minor revisions of Regulation Z. We also urge the Board to adopt our proposed revision to the timing rules for estimated disclosures at the same time. Since the Board is contemplating a comprehensive review of the HELOC disclosure requirements in the near future, it might be reasonable to defer consideration of HELOC changes until then.

Thank you for considering this proposal.

Sincerely,

Carolyn Carter, Consumer Advisory Council Member
Diane E. Thompson, Consumer Advisory Council Member, 2002-2005

Cc: Sandra Braunstein
Adrienne Hurt
Leonard Chanin
James Michaels

APPENDIX A: PROPOSED VARIABLE RATE DISCLOSURES FOR CLOSED-END CREDIT

Sample Truth In Lending Disclosure Statement

ANNUAL PERCENTAGE RATE The cost of your credit as a yearly rate.	**FINANCE CHARGE** The dollar amount the credit will cost you.	**Amount Financed** The amount of credit provided to you on your behalf.	**Total of Payments** The amount you will have paid after you have made all payments as scheduled.

You have the right to receive at this time an itemization of the Amount Financed.

☒ I want an itemization ☐ I do not want an itemization

Your payment schedule will be:

Number of Payments	Amount of Payments	When Payments Are Due

Variable Rate Information

This is a variable rate loan and your interest rate and monthly payment can change substantially over time. The monthly payment listed above is for an initial period of ____ months.

The **maximum** interest rate that you can be charged at any time during this loan is _____%. If the rate goes as high as is allowed under your loan note, your **maximum** monthly payment would be $_______(based upon the initial principal amount).

The index that will be used to calculate your interest rate can be found on the Internet at____.

Insurance
Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost.

Type	Premium	Signature
Credit Life		I want credit life insurance Signature:
Credit Disability		I want credit disability insurance Signature:
Credit Life and Disability		I want credit life and disability insurance Signature:

You may obtain property insurance from anyone you want that is acceptable to (creditor). If you get the insurance from (creditor) you will pay $ ______________.

Security: You are giving a security interest in:
☒ the goods or property being purchased
☐ (brief description of other property)

Filing fees $__________ **Non-filing insurance** $_______

Late Charge: If a payment is late, you will be charged $_______/______% of the payment.

Prepayment: If you pay off early, you

☒ may	☐ will not	have to pay a penalty.
☐ may	☒ will not	be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

APPENDIX B

PROPOSED DISCLOSURES AT TIME ACCOUNT IS OPENED FOR HOME EQUITY LINES OF CREDIT WITH VARIABLE RATE FEATURE

Annual percentage rate	Initial rate ___________% Maximum rate ___________% Note: the annual percentage rate does not include costs other than interest.
Variable rate information	Your annual percentage rate may vary substantially during the time you maintain an account with us. The rate is determined by (explanation).
Maximum amount of credit available to you **Initial amount of credit extended to you** **Remaining credit available to you**	1._____________ 2._____________ 3._____________(difference between lines 1 and 2)
Minimum monthly payment (based on the initial amount of credit extended to you at the initial annual percentage rate) **Number of months to repay at minimum monthly payment** (assuming no change in the initial APR)	______________ _______________
Example of highest payment that could be due under the plan	Here is an example of how the monthly payment on your loan may increase: The **maximum amount** you can borrow is _______________. At that amount, , the starting monthly payment at your initial interest rate would be ____________. However, if the interest rate on your loan were the **maximum rate** ____%, the monthly payment would be ___________. The index that will be used to calculate your interest rate can be found on the Internet at____.
Total costs to obtain this line of credit	$_____________(See the HUD-1 Settlement Statement for an itemized list of charges)
Grace period	You have [__ days] [until _____] [not less than ____ days] [between ___and ___ days] [____ days on average] to pay the

	minimum payment due (for purchases) before a finance charge will be in imposed]. [If interest is to be charged during the grace period, this fact must be stated here.]
Transaction fee for additional cash draws or for exceeding the credit limit	Transaction fee for cash draws: [$______] [____% of _____] Over-the-credit-limit fee: $____________

Insurance
Credit life insurance and credit disability insurance are not required to obtain credit, and will not be provided unless you sign and agree to pay the additional cost.

Type	Premium	Signature
Credit Life		I want credit life insurance Signature:
Credit Disability		I want credit disability insurance Signature:
Credit Life and Disability		I want credit life and disability insurance Signature:

You may obtain property insurance from anyone you want that is acceptable to (creditor). If you get the insurance from (creditor) you will pay $ ______________.

Security: You are giving a security interest in:
☒ the goods or property being purchased
☐ (brief description of other property)

Filing fees $___________ **Non-filing insurance** $_______

Prepayment: If you pay off early, you
☒ may ☐ will not have to pay a penalty.
☐ may ☒ will not be entitled to a refund of part of the finance charge.

See your contract documents for any additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties.

NOTE: Other variable rate provisions may be made in the credit card agreement.